

Direct Testimony

of

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Financial Analysis Division

Illinois Commerce Commission

Illinois-American Water Company

and

Thames Water Aqua Holdings, GmbH

Docket No. 01-0832

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## **SCHEDULE**

SCHEDULE 2.1 – RWE CAPITAL STRUCTURE

**INTRODUCTION**

**Q. Please state your name, employer and business address.**

A. My name is Rochelle Langfeldt. I am employed by the Illinois Commerce Commission ("Commission"). My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

**Q. What is your current position with the Commission?**

A. I am a financial analyst in the Finance Department of the Financial Analysis Division.

**Q. Please describe your qualifications and background.**

A. In May 1998, I received a Bachelor of Arts degree in Finance from Illinois College, Jacksonville, Illinois. In May 2000, I received a Master of Business Administration degree from the University of Illinois at Springfield. I have been employed by the Commission since June 2000.

**Q. What is the purpose of your testimony in this proceeding?**

A. I will present my evaluation of the reorganization, hereafter, referred to as the "Transaction", proposed by Illinois-American Water Company ("Illinois-American" or "Company") and Thames Water Aqua Holdings, GmbH ("Thames Holdings"), under Sections 7-204(b)(4) and 6-103 of the Public Utilities Act ("Act"). Section 7-204(b)(4) pertains to the Transaction's financial implications on Illinois-American's ability to access the capital markets on reasonable terms and maintain a reasonable capital structure. Section 6-103 pertains to Illinois-American's capitalization following the Transaction.

**Q. Please describe the Transaction.**

A. Illinois-American, on behalf of itself and its parent company, American Water Works Company, Inc. ("American"), and Thames Holdings, on behalf of itself and its parent company, RWE Aktiengesellschaft ("RWE"), request approval of the transaction described in an Agreement and Plan of Merger ("Agreement"), provided as Exhibit A in the appendix to the Company's Verified Application. The Agreement is among Thames Holdings, RWE, American, and Apollo Acquisition Company ("Acquisition Corp.").<sup>1</sup> Following the Transaction, Illinois-American will continue to be American's subsidiary and will continue to exist as an Illinois public utility subject to the jurisdiction and regulation of the Commission.<sup>2</sup>

The Agreement provides for Thames Holdings to acquire all of American's stock as follows: (1) each outstanding share of American common stock not owned by Thames Holdings, Acquisition Corp. or American, will be converted into the right to receive cash as consideration in the amount of \$46.00 per share; (2) each outstanding share of American preferred stock will be redeemed at \$25.25 per share, plus full cumulative dividends; and, (3) each outstanding share of American preference stock will be redeemed at \$25.00 per share, plus full cumulative dividends.<sup>3</sup>

RWE would provide Thames Holdings with sufficient funds to consummate the transaction.<sup>4</sup> RWE would secure the \$7.6 billion required to consummate the acquisition primarily through issuing bonds.<sup>5</sup>

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<sup>1</sup> Acquisition Corp. is a wholly owned subsidiary of Thames Holdings created for the purpose of implementing the Agreement. Upon closing of the Transaction, Acquisition Corp. will be merged into American and American will be the surviving corporation. Company's Verified Application at 1.

<sup>2</sup> *Ibid.* at 1-2.

<sup>3</sup> *Ibid.* at 3-4.

<sup>4</sup> *Ibid.* at 4.

**Q. Please summarize your findings and recommendations.**

A. Section 7-204(b)(4) of the Act requires the Commission find that the Transaction would not significantly impair Illinois-American's ability to raise capital on reasonable terms or maintain a reasonable capital structure. Based on my analysis, the Transaction's impact on Illinois-American's ability to access capital markets and maintain a reasonable capital structure is uncertain and therefore does not satisfy the Section 7-204(b)(4) requirements. To satisfy the Section 7-204(b)(4) requirements, RWE must show how it will achieve a capital structure following the Transaction that is reasonable by U.S. standards. Alternatively, RWE must demonstrate that debt ratios approaching 70% are reasonable by European standards and would not impair Illinois-American's ability to access the capital markets or maintain a reasonable capital structure.

The Transaction complies with the requirement of Section 6-103 of the Act since Illinois-American's capitalization will not change following the Transaction.

#### **SECTION 7-204(b)(4): ACCESS TO CAPITAL MARKETS**

**Q. Why is it necessary to evaluate the financial implications of the Transaction?**

A. Under Section 7-204(b)(4) of the Act, the Commission must find that the Transaction "will not significantly impair the utility's ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure."<sup>6</sup>

**Q. How does Illinois-American currently obtain capital?**

A. Illinois-American obtains equity capital through American. Additionally, in Docket No. 00-0306, the Commission approved an agreement between American Water

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<sup>5</sup> Company response to Staff data request RL 2.01.

<sup>6</sup> 220 ILCS 5/7-204.

Capital Corporation (“AWCC”) and Illinois-American, both wholly owned subsidiaries of American. Under the terms of the agreement approved by the Commission in Docket No. 00-0306, AWCC provides Illinois-American with access to short-term and long-term debt capital on behalf of American. American supports AWCC’s credit with a support letter guaranteeing repayment.<sup>7</sup>

**Q. Does AWCC currently have access to the capital markets on reasonable terms?**

A. Yes. Standard & Poor’s (“S&P”) categorizes debt securities on the basis of the risk that a company will default on its interest or principal payment obligations. The resulting credit rating reflects both the operating and financial risks of a utility.<sup>8</sup> S&P rates AWCC “A-.”<sup>9</sup> This credit rating reflects the strong support arrangement with its parent company, American.<sup>10</sup>

**Q. How would Illinois-American obtain equity capital following the Transaction?**

A. Following the Transaction, American would remain the sole provider of common equity capital to Illinois-American.<sup>11</sup> Nonetheless, the Transaction would result in RWE becoming American’s parent company and ultimately, RWE would be responsible for providing equity capital to Illinois-American if American did not have sufficient funds on hand.

**Q. How would Illinois-American obtain debt capital following the Transaction?**

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<sup>7</sup> Order, Docket No. 00-0306, May 16, 2000, at 1-4.

<sup>8</sup> Standard & Poor’s Utilities Rating Service, “Utilities Rating Criteria,” May 20, 1996, at 1.

<sup>9</sup> According to S&P, an A-rated utility has a strong capacity to meet its financial obligations. Standard & Poor’s Ratings Definitions, December 21, 2001, at 1-2.

<sup>10</sup> Standard & Poor’s, Summary: American Water Capital Corp., January 17, 2002.

<sup>11</sup> Company response to Staff data request RL 1.03.

99 A. Following the Transaction, AWCC or Illinois-American, whichever can provide  
100 financing at a lower cost, would be the entity responsible for raising debt capital in  
101 accordance with the agreement approved by the Commission in Docket No. 00-  
102 0306.<sup>12</sup>

103  
104 **Q. How would the Transaction impact Illinois-American's access to capital**  
105 **markets?**

106 A. The Transaction's impact on Illinois-American's access to capital markets is  
107 uncertain. It depends upon how RWE finances the Transaction and how RWE  
108 manages its capital structure following the Transaction.

109  
110 **Q. Could Illinois-American's access to the capital markets increase following**  
111 **the Transaction?**

112 A. Yes. Illinois-American's access to capital markets could potentially increase  
113 following the Transaction since Illinois-American would become an indirect  
114 subsidiary of RWE. S&P rates RWE "AA-,"<sup>13</sup> which is higher than AWCC's current  
115 "A-" credit rating. Moreover, when RWE acquired Thames Water Plc,<sup>14</sup> an S&P  
116 associate stated that it is apparent that water activities are a key part of RWE's  
117 portfolio, and that the operations cannot be separated on a rating basis.<sup>15</sup> Thus,  
118 when RWE acquired Thames Water Plc, S&P raised the credit ratings of Thames  
119 Water Plc and its subsidiaries to "AA-" from "A+." According to S&P, RWE's higher  
120 credit strength enhanced the underlying credit quality of Thames Water Plc.<sup>16</sup>  
121 Although S&P raised Thames Water Plc's credit rating when it was acquired by

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<sup>12</sup> Company response to Staff data request RL 1.02.

<sup>13</sup> According to S&P, an AA-rated utility has a very strong capacity to meet its financial obligations. Standard & Poor's Ratings Definitions, December 21, 2001, at 1-2.

<sup>14</sup> Thames Water Plc operates all of the water business of Thames Holdings' subsidiaries and would operate American's utility subsidiaries upon completion of the Transaction. Company's Verified Application, Exhibit G.

<sup>15</sup> Standard & Poor's, "Ratings on Thames Water and Units Raised to 'AA-'; Off Watch; Outlook Negative," December 20, 2001.

RWE, there is no guarantee that the same would occur with respect to American following the Transaction.

**Q. Given that RWE has a higher credit rating than AWCC, why do you describe the Transaction's effect on Illinois-American's access to the capital markets as uncertain?**

A. On December 20, 2001, S&P assigned RWE and its subsidiaries a negative outlook<sup>17</sup> that reflects S&P's assessment of RWE's acquisition of Transgas, a Czech Republic-based gas monopoly. The approved bid for Transgas is 4.1 billion euros and expected to be fully debt-financed.<sup>18</sup> According to S&P, this would materially erode headroom for additional acquisitions at the current "AA-" credit rating.<sup>19</sup> The Company has indicated that the capital required for the Transgas acquisition would be obtained through the divestiture of disposable assets valued at approximately six billion euros.<sup>20</sup> Conversely, the Transaction is valued at approximately nine billion euros,<sup>21</sup> (double the value of the Transgas acquisition) and RWE has not indicated how it would be financed. Thus, one must assume that the Transaction would be financed entirely with debt capital, which could materially erode RWE's credit ratings. This would ultimately impair Illinois-American's access to the capital markets because S&P could rate RWE and its subsidiaries on a consolidated basis.

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<sup>16</sup> *Ibid.*

<sup>17</sup> Negative Outlook means that a rating may be lowered. S&P Rating Outlooks assess the potential direction of a long-term credit rating over the intermediate to longer term. An Outlook is not necessarily a precursor of a rating change. Standard & Poor's Ratings Definitions, December 21, 2001, at 6.

<sup>18</sup> Standard & Poor's, Research: RWE AG, February 13, 2002, at 2.

<sup>19</sup> Standard & Poor's, "Ratings on Thames Water and Units Raised to 'AA-'; Off Watch; Outlook Negative,," December 20, 2001.

<sup>20</sup> The disposable assets that would be divested include Hochtief AG, Heidelberger Druckmaschinen AG and DEA AG. Company supplemental response to Staff data request RL 2.03.

<sup>21</sup> *Ibid.*



**Q. How would the additional financing required to accomplish the Transaction impact RWE's capital structure?**

A. RWE's current capital structure is comprised of approximately 56% debt and 44% equity.<sup>22</sup> At this time, RWE will not commit to a definitive capital structure following the Transaction and reflecting all additional financing.<sup>23</sup> Thus, I examined RWE's capital structure following the Transaction, assuming that the Transaction is financed with 100% debt capital. If this would occur, RWE's capitalization would be comprised of approximately 67% debt and 33% equity.<sup>24</sup> Schedule 2.1 presents RWE's pro forma capital structure.

**Q. Please explain why RWE's 67% debt ratio following the Transaction would be problematic.**

A. S&P has assigned RWE a business profile score of 4.5.<sup>25</sup> The S&P benchmarks established for U.S. utilities with business profile scores of 4 and 5 indicate that debt ratios should fall within the 47% to 57% range to remain investment grade (i.e., 'BBB' or higher). A 67% debt ratio reflects the benchmark for speculative rated utilities (i.e., below investment grade).<sup>26</sup> This high degree of financial leverage would significantly impair a U.S. utility's access to the capital markets.

**Q. Do the S&P financial benchmarks for U.S. utilities also apply to European utilities?**

A. The answer is unclear. I understand that RWE's financial statements follow international rather than U.S. accounting standards. Therefore, a 67% debt ratio may connote a different degree of financial strength under international accounting

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<sup>22</sup> Ibid.

<sup>23</sup> Company response to Staff data request RL 2.01.

<sup>24</sup> Company supplemental response to Staff data request RL 2.03.

<sup>25</sup> Standard & Poor's, *Utilities & Perspectives*, March 11, 2002 at 20.

<sup>26</sup> Standard & Poor's, *Utility Financial Targets are Revised*, June 18, 1999.

standards than under U.S. accounting standards. However, I have not been able to find any benchmarks for European utilities. Before the Transaction would satisfy the requirements of Section 7-204(b)(4) of the Act, Illinois-American must demonstrate that a 67% debt ratio is not problematic by European standards and would not significantly impair the Company's ability to access to the capital markets or maintain a reasonable capital structure. Alternatively, RWE must show how its financing program will allow it to maintain a debt ratio consistent with S&P benchmarks for U.S. utilities with investment grade credit ratings.

### **SECTION 6-103: CAPITALIZATION OF THE NEW UTILITY**

**Q. Why is it necessary to review the capitalization of a public utility following reorganization?**

A. Section 6-103 of the Act requires that in any reorganization, the Commission shall authorize the amount of capitalization of a public utility formed by a merger, which shall not exceed the fair value of the property involved.<sup>27</sup>

**Q. How will the Transaction affect Illinois-American's capital structure?**

A. Currently, Illinois-American's capital structure is comprised of approximately 55% debt and 45% equity.<sup>28</sup> These capitalization ratios are consistent with the Company's target capital structure of 40% to 50% equity and 50% to 60% debt. Illinois-American's capital structure will not change as a result of the Transaction.<sup>29</sup>

**Q. Does this conclude your prepared direct testimony?**

A. Yes.

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<sup>27</sup> 220 ILCS 5/6-103.

<sup>28</sup> Company's Verified Application, Exhibit J.

<sup>29</sup> Company response to Staff data request RL 1.04.

RWE Capital Structure  
(In Million Euros)

	June 30, 2001		Pro Forma	
	Balance	Ratio	Balance	Ratio
<u>Common Equity</u>				
Common Shares	€ 1,359		€ 1,359	
Preference Shares	100		100	
Capital Reserve	1,269		1,269	
Retained Earnings	4,312		4,312	
Distributable Profit	281		281	
Minority Interest	3,522		3,522	
Adjustments from IAS to U.S. GAAP:				
Goodwill Amort. (20 yrs. v. 40 yrs.)			223	
Depreciation Lives (19 yrs. v. 32 yrs.)			306	
<b>Total Common Equity</b>	<b>€ 10,843</b>	<b>43.7%</b>	<b>€ 11,372</b>	<b>33.1%</b>
<u>Debt</u>				
Loans	€ 3,579		€ 3,579	
Loans Against Borrowers' Notes	3,451		3,451	
Accounts Payable to Banks	6,962		6,962	
Acquisition of American	0		8,740	
Adjustments from IAS to U.S. GAAP:				
Finance Lease (Capital Leases)			230	
<b>Total Debt</b>	<b>€ 13,992</b>	<b>56.3%</b>	<b>€ 22,962</b>	<b>66.9%</b>
<b>Total Capitalization</b>	<b>€ 24,835</b>	<b>100.0%</b>	<b>€ 34,334</b>	<b>100.0%</b>

Source: Company's supplemental response to Staff data request RL 2.03.

I adjusted RWE's pro forma capital structure by not reflecting maturing debt issues because there was no evidence supporting RWE's claim that these maturing debt issues would not be replaced with new debt.